COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Petition of Berkshire Gas Company for the Approval of the Issuance from Time to Time of Long-Term Debt Securities in an Amount not to Exceed $20,000,000	D.T.E. 03-89

INITIAL BRIEF OF THE ATTORNEY GENERAL

I. SUMMARY

The Attorney General submits this Initial Brief to address the petition ("Petition") filed by Berkshire Gas Company ("Berkshire" or the "Company") with the Department of Telecommunications and Energy ("Department"). The Department should deny Berkshire's request to issue new debt in the amount of $20 million because the Company has not met the Department's net plant test. The Department should also deny the Company's request to engage in "interest rate mitigation transactions" or financial derivatives trading because these proposed hedging activities are likely to harm customers.

II. INTRODUCTION

The Company asks the Department to authorize, pursuant to G.L. c.164, §14, the issuance from time to time through January 31, 2007 up to $20 million in long-term debt. Berkshire says the new debt would be used for: (1) the payment of maturity of certain outstanding indebtedness and equity securities; (2) the payment of capital expenditures for properly capitalizable additions to property, plant, and equipment, or for the payment of obligations of the Company incurred for such expenditures; (3) the refinancing of short-term debt and long-term securities; (4) for general working capital purposes; and / or (5) for such other purposes as the Department may authorize. Berkshire asks the Department to exempt it from: (1) the requirements of G.L. c.164, §15-A, that the Company issue any long-term debt securities at par; and (2) the competitive bidding requirements of G.L. c.164, §15, in connection with the sale of any long-term debt securities. Berkshire also asks the Department to approve the transactions contemplated by the Petition, including novel interest rate mitigation transactions described therein.

III. STANDARD OF REVIEW

Before approving the issuance of stock, bonds, coupon notes, or other types of long-term indebtedness by an electric or gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations. G.L. c. 164, § 14; *Fitchburg Gas & Electric Light Company v. Department of Public Utilities*, 395 Mass. 836, 842 (1985), citing *Fitchburg Gas & Electric Light Company v. Department of Public Utilities*, 394 Mass. 671, 678 (1985). Second, the Department must determine whether the Company has met the "net plant" test, which is derived from G.L. c. 164, § 16. *Colonial Gas Company*, D.P.U. 84-96 (1984).

An electric or gas company offering long-term bonds or notes in excess of $1 million in face amount must invite purchase proposals through newspaper advertisements. G.L. c. 164, § 15. The Department may grant an exemption from this advertising requirement if the Department finds that an exemption is in the public interest. *Id*.

IV. ARGUMENT

A. The Company's Proposed Financing Does Not Meet The Department's Net Plant Test.

The Company has failed to meet the Department's well established "net plant test" for approval of its $20 million proposed financing. Under the net plant test:

> a company is required to present evidence that its net utility plant (original cost of capitalized plant, less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common stock outstanding) and will continue to do so following the proposed issuance.

Commonwealth Electric Company, D.T.E. 02-51, p. 4, *citing Colonial Gas Company*, D.P.U. 84-96, p. 5 (1984). Berkshire has failed to show that the current amount of net plant exceeds its total capitalization by the requested financing amount of $20 million.

The Company's net plant only exceeds its capitalization by, at most, $7.75 million as of September 2003 (the Excess of Net Plant to Total Securities and Debt amount of $3,047,000 shown on Exh. BG-7, Exhibit KLZ-5, as of June 30, 2003 plus the amount of the Commercial Note due September of 2003 in the amount of $4,705,400). The Company speculates about other capital additions and debt retirement for the years 2004 through 2006, but such speculation does not provide sufficient substantiation to justify additional financing at this time. *See* Exh. BG-8, pp. 1-2 (Exhibit KLZ-6). The Department should reject the Company's request for financing $20 million and instead authorize approval of $7.75 million.

The Department has conditionally approved some financings where the utility's balance sheet does not currently meet the net plant test. *See e.g., Commonwealth Electric Company*, D.T.E. 02-51, pp. 7-8 (2002); *Boston Edison Company*, D.T.E. 00-62, pp. 10-11 (2000); *East Northfield Water Company*, D.P.U. / D.T.E. 97-36, pp. 6-7 (1997); *Colonial Gas Company*, D.P.U. 95-76, pp. 7-8 (1995). The Department has required in those cases, however, that a company make a supplemental compliance filing showing that it meets the Department's net plant test at that time. *Id*. If the Department approves any amount over $7.75 million at this time, it should, consistent with precedent, condition that approval on Berkshire's making contemporaneous compliance filings showing that the additional financing meets the net plant test, to ensure that such financing complies with G.L. c. 164 §§ 14 and 16.

B. The Department Should Deny The Company's Proposal To Enter Into Financial Derivatives Markets.

The Company asks the Department to allow it to trade financial derivatives. Petition, pp. 3-4; Exh. BG-1, p. 3. Company shareholders would bear the costs, gains, and losses associated with the trading during the remainder of Berkshire's existing ten-year price cap plan, but could pass on those gains and losses thereafter. The Department should deny the Company's request, however, because the proposal will harm customers both during and after the ten-year price cap plan, for the reasons discussed below.

1. Trading Financial Derivatives Is Not Necessary To Provide Utility Service.

Berkshire asks the Department to grant the Company blanket approval to trade financial derivatives.[1] Petition, p. 3-4; Exh. BG-1, p.3. The Department must determine whether the Company's request and related use of the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations. G.L. c. 164, § 14; *Fitchburg Gas & Electric Light Company v. Department of Public Utilities*, 395 Mass. 836,

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[1] The Company does not propose any limits on types of derivatives traded, the dollar amount traded, the value at risk, or the persons doing the trading. BG-1, pp. 17-19. The only limits are that trading will be for hedging purposes only and will not be "speculative" in nature according to accounting standards. *Id*., p. 19.

842 (1985) ("*Fitchburg II*"), *citing Fitchburg Gas & Electric Company v. Department of Public Utilities*, 394 Mass. 671, 678 (1985) ("*Fitchburg* I"). The Company's has not shown that its hedging proposal is "reasonably necessary" or that it would accomplish a "legitimate purpose" related to meeting Berkshire's service obligations. To the contrary, the hedging proposal would harm ratepayers by increasing the investment risk profile of the Company while benefitting only the Company's shareholders. The Department therefore should deny the Company's blanket request to trade financial derivatives.

2. The Department Should Not Allow Berkshire To Retain Financial Trading Benefits Because That Would Harm Customers By Putting The Company's Interests In Direct Conflict With Those Of Its Customers.

Berkshire purposes to retain the gains (and the losses) from derivatives trading. Tr. 1, p. 33. This proposal sets up an inherent conflict between shareholder and customer interests that would harm customers.

The gains and losses from the bets that the Company will place with the financial derivatives will depend on the interest rates associated with the Company's securities. Since the Company will also be negotiating the terms of the securities issues, including the maturity, interest rate, and fixed versus variable components, Berkshire will no longer have an incentive to negotiate the best terms for customers in the original instrument. Instead, Berkshire would have an incentive to use derivative securities to reverse the terms of the original instrument so that its shareholders will profit from the correction. Two simple examples illustrate the inherent conflict of having an incentive mechanism where a utility negotiates the benchmark, in this case the terms of the instrument, as well as the derivatives from which it profits.

First, when the Company believes that long-term interest rates will trend down in the future, it could issue long-term bonds with a fixed interest rate. Then, immediately after issuing the bonds, the Company could trade over-the-counter and swap its fixed interest rate for a variable interest rate instrument. This scheme would burden customers with the higher fixed rate debt, while allowing the Company to benefit from riding the curve as interest rates decrease in the future.

A second example would be the inverse of the first, where the Company believes that interest rates will increase in the future. This time the Company could issue variable interest rate bonds to the market and immediately afterwards swap the variable for a fixed investment rate instrument. This scheme would burden customers with higher costs as interest rates rise over time, whereas the Company's shareholders profit from having swapped to fixed rates.

These examples demonstrate the ease with which the Company can profit inappropriately from its financing and hedging activities. Customers will be harmed, since the utility will always be trading against the economics of the original issue.

3. The Company Has Not Demonstrated That It Has The Appropriate Internal Controls Or The Necessary Expertise To Trade Financial Derivatives.

The Department should deny Berkshire's proposal to trade financial derivatives because the Company has not shown that it has the appropriate internal controls or the necessary expertise to trade financial derivatives successfully. Berkshire has not shown that its employees have any experience in trading financial derivatives.[2] Tr. 1, pp. 21-22. Any Management

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[2] Q. Has the company utilized interest rate locks in previous debt financings?

A. I don't know that we've used this particular type of transaction that I just discussed. There may have been something else used in the past that I would have to get back to you on. As far as whether we've ever done anything like this before, for me this is a new concept of not coming in ahead of time with: here is the transaction that we propose, Company Employee of Energy East can perform the hedging activities for the Company under the Energy East Derivative Trading Policy. Exh. BG-12, p. 2 (Exhibit KLZ-10). The head of Human Resources or Customer Relations, for example, may trade derivatives for the Company even though they have no knowledge of or experience in trading financial derivatives. There are no requirements that employees be educated and licensed to perform financial derivative trades. *Id*. Yet, the Company proposes that these employees be allowed to trade any financial derivatives, in any amounts. The Department should deny the Company's request to enter into hedging activities because its employees lack the requisite experience in trading financial derivatives. Inexperienced traders could cause severe financial harm to the Company, even bankruptcy.

4. The Company Does Not Need To Issue Derivatives To "Lock In" Interest Rates On Its Issues Since They Will Be Private Placements.

The Company indicated that its financings will be private placements, since they provide the least cost method of issuing debt in such small principle amounts. Exh. BG-1, pp. 10-17. Private placements are financial arrangements with institutions; they are tailored to the needs of the Company and the institution. Private placements avoid the long formal process and notices required of a public offering.

With a little foresight and planning, the private placement should be accomplished in a relatively short time, given the extremely flexible nature of the financing that the Company is requesting from the Department. There should be no need to "lock in" interest rates for the brief

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here is what we are going to use as the investor, here is what the interest rate is.

Tr. 1, pp. 21-22.

period between when the Company believes, rightly or wrongly, that interest rates are optimal and when the issuance actually takes place. Berkshire's ability to issue private placements should obviate the need to "lock in" interest rates on these debt issuances.

V. CONCLUSION

The Department should approve only $7.75 million of long-term debt financing, not the $20 million Berkshire requests, or at least require compliance filings with each issuance showing that it meets the Department's net plant test. The Department should deny Berkshire's request to allow it to trade financial derivatives, since that would harm the Company's customers.

RESPECTFULLY SUBMITTED,

TOM REILLY
ATTORNEY GENERAL

By: Alexander Cochis
Assistant Attorney General
Utilities Division
200 Portland Street
Boston, MA 02114
(617) 727-2200

Dated: December 11, 2003